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The de-globalization fallacy

Rising political tensions are changing globalization, not ending it.

Deeper analysis of investment trends and topics **September 6, 2022**

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Key takeaways

- Globalization has been adapting for decades, despite an increase in domestic and international political tensions.
- Likewise, we are seeing U.S. companies adjust their supply chains, not bring them home, despite the disruptions of war and the pandemic.
- We show how globalization is adapting, not ending or reversing, and believe these adjustments bear watching for potential investment opportunities over the coming decade.

Is this the twilight of globalization? Goods trade as a share of total global economic output did appear to peak in 2008, and suffered another setback during the pandemic. Our September 2021 report on investment opportunities from globalization presented our view that worsening political tensions in the past decade will accelerate globalization's transformation, not end it. This report extends the analysis and concludes that the world economy is adapting to surging global services demand and political pressures, including calls for simpler and more resilient global supply chains.[1]

The report addresses the following questions:

- Will events around the world damage or reverse globalization?
- How do we expect globalization to evolve over the coming decade, especially with respect to supply chains?

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1. "The future of globalization: Investing in an interconnected world", September 2021, Wells Fargo Investment Institute.

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Will events around the world damage or reverse globalization?

U.S.-China tensions — and more recently, the Russia-Ukraine war and the Western powers' retaliatory sanctions — have raised new concerns about the future of globalization. Some perspective is in order.

Adjustments to the Russia-Ukraine war likely will reroute trade to replace lost Russian production

The war in Ukraine is forcing Europe to increase defense budgets. Long-time neutrals Sweden and Finland are close to finalizing NATO (North Atlantic Treaty Organization) membership, and the European Union must rethink its energy strategy. In mid-2022, Russia reduced natural gas flows to 20% of capacity via northern Europe's most important natural gas source, the Nord Stream 1 pipeline. This cut might retaliate for Western sanctions over Russia's invasion of Ukraine. Rather than fracturing global trade, however, this and other sanctions could redirect trade in the coming years.

- Canada is similar to Russia longitudinally and geographically, and is able to make up some of the lost Russian supply of uranium, nickel, potash, wheat, and crude oil.
- Australia can divert more industrial metals to the rest of the world as China buys Russian metals.
- Other countries can fill in the shortfall, too: Argentina or India for wheat, South Africa for platinum and palladium, and the Organization of Petroleum Exporting Countries (OPEC) or even Brazil and the U.S. for crude oil. These countries may not quickly or fully replace the sanctioned Russian supply today, but they may reduce dependence on Russia. Most of all, they are available because of broad-based global markets.

"But if thought corrupts language, language can also corrupt thought. A bad usage can spread by tradition and imitation even among people who should and do know better." — George Orwell, *Politics and the English Language.*

Fears of a Cold War appear overdone

In looking for investment opportunities globally, we find it unhelpful to divide the world into free and unfree societies, or according to whether they lie in China's or Russia's political sphere of influence. To apply Mr. Orwell's observation, the term "Cold War" triggers memories that poorly describe today's world and investment opportunities.

The Cold War was about bipolar competition ideologically, militarily, diplomatically, and economically. U.S.-Russia competition still carries a nuclear risk, but important differences make today mostly unlike the 1945 – 1991 Cold War period. During that era, Russia dominated all of Eastern Europe. Today, most of Eastern Europe are NATO members.[2]

It is not even clear that Russia can win a war of attrition in Ukraine. Moscow's military losses have forced it to throw obsolete equipment into the fight, even as Russia so far holds only one-fifth of Ukraine, even after concentrating its forces and dramatically shortening supply lines since spring 2022.[3] And recent Russian government decrees show Moscow straining financially to recruit new soldiers, and ordering the entire economy to produce war material for use in Ukraine.[4]

We do foresee a bipolar competition in the coming decade between China and the U.S., but their economic symbiosis is deep and evidence suggests the link will be difficult to break. At a high level, U.S. trade with China jumped 20% in 2021, to over $687 billion, and foreign direct investment climbed to a four-year high of $1.65 trillion in 2021.[5] As we discuss on page 3, U.S. companies that rely on China's factories have a strong incentive to adjust, but not eliminate, their supply chains across the Pacific Ocean.

2. Source: "NATO on the Map", North Atlantic Treaty Organization, www.nato.int, August 19, 2022.
3. "Russia Turns to Old Tanks as It Burns Through Weapons in Ukraine", Bloomberg, Alberto Nardelli, June 14, 2022
4. "Russian Operations Assessment", Institute for the Study of War, July 11, 2022 and August 12, 2022.
5. United Nations Conference on Trade and Development (UNCTAD), *Global Investment Trend Monitor* No. 40, January 19, 2022.

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In a sign of continuing cooperation despite their growing competition, U.S. and Chinese government negotiators agreed in August 2022 to allow the U.S. auditor watchdog access to the audits of Chinese companies listed on U.S. exchanges. More work remains to establish working routines for reviewing the audits of Chinese American Depositary Receipts (ADRs). However, the agreement breaks through on a standoff that has run for more than a decade.

The symbiosis is most clear at the industry level. Most microchips for cars and electronic devices come from Taiwan, and the pandemic's chip supply disruption exposed a U.S. security risk from this reliance. A brand new U.S. law provides $52 billion in subsidies to increase U.S. microchip production, but this total pales by comparison with the $100 billion, three-year capital expansion plan of the world's largest contract semiconductor firm in Taiwan. Meanwhile, U.S. policy is trying to block China's purchases of deep ultraviolet lithography machines, used to make advanced semiconductor chips.[6]

In sum, what the U.S. lacks in chip production, China lacks in technology and research and development. Neither country is likely to become self-sufficient in these electronic building blocks anytime soon.

Thinking more broadly about trade, U.S.-China economic and political competition seems set to increase, but this is very different from the economic and political separation that characterized the U.S.-Russia standoff during the Cold War.

Finally, geographic or ideological proximity to China or Russia does not necessarily limit its global trade opportunities. Countries are relying more and more on treaties to increase trade in a targeted way — with one or several other countries, and in particular industries — while selectively excluding other industries. These regional trade agreements (RTAs) are often between countries that are mostly democracies (Group 1 in Table 1). However, nearly as many RTAs (75) are between Group 1 and Group 2, which includes countries that tend to fall under the influence of Russia and China, or that are not aligned with major political blocks.[7]

Regional trade today involves most of the world, whether one or more of the parties in an RTA is tied to Russia or China, or is politically unaligned. RTAs continue to gain popularity — despite the fade in goods trade since 2008, Brexit, and the increase in geopolitical tensions. No ideological split prevents trade today.

Table 1. Regional trade agreements (RTAs) made or joined from 2005 – 2021 by countries within and across two groupings

	RTAs with Group 1	RTAs with Group 2
Group 1, includes: ▪ The Western Hemisphere ▪ Europe (excludes Russia, Belarus, Ukraine, Moldova) ▪ Japan and South Korea ▪ Australia and New Zealand	76	75
Group 2, includes: ▪ China ▪ North Korea ▪ South Asia (Pakistan, Nepal, Bhutan, Myanmar, Laos, Thailand, Cambodia, Vietnam, Indonesia, Malaysia, Sri Lanka, the Philippines) ▪ Russia, Belarus, Ukraine, Moldova ▪ Africa ▪ The Middle East (including Turkey)	75	25

Sources: World Trade Organization and Wells Fargo Investment Institute, August 15, 2022.

6. The new law is the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act (2022). For more details on the mutual U.S.-China dependence, please see "The CHIPS Act Won't Reduce the U.S.'s Strategic Reliance on the Global Semiconductor Sector", RANE Worldview, July 28, 2022; and "To Slow China's Semiconductor Sector, the U.S. Eyes More Export Bans", RANE Worldview, July 11, 2022.
7. The Non-Aligned Movement is a group of states that do not formally align with or against any major global power block. Most of them are in Africa and the Middle East. Source: United Nations Economic and Social Commission for Western Asia, August 1, 2022.

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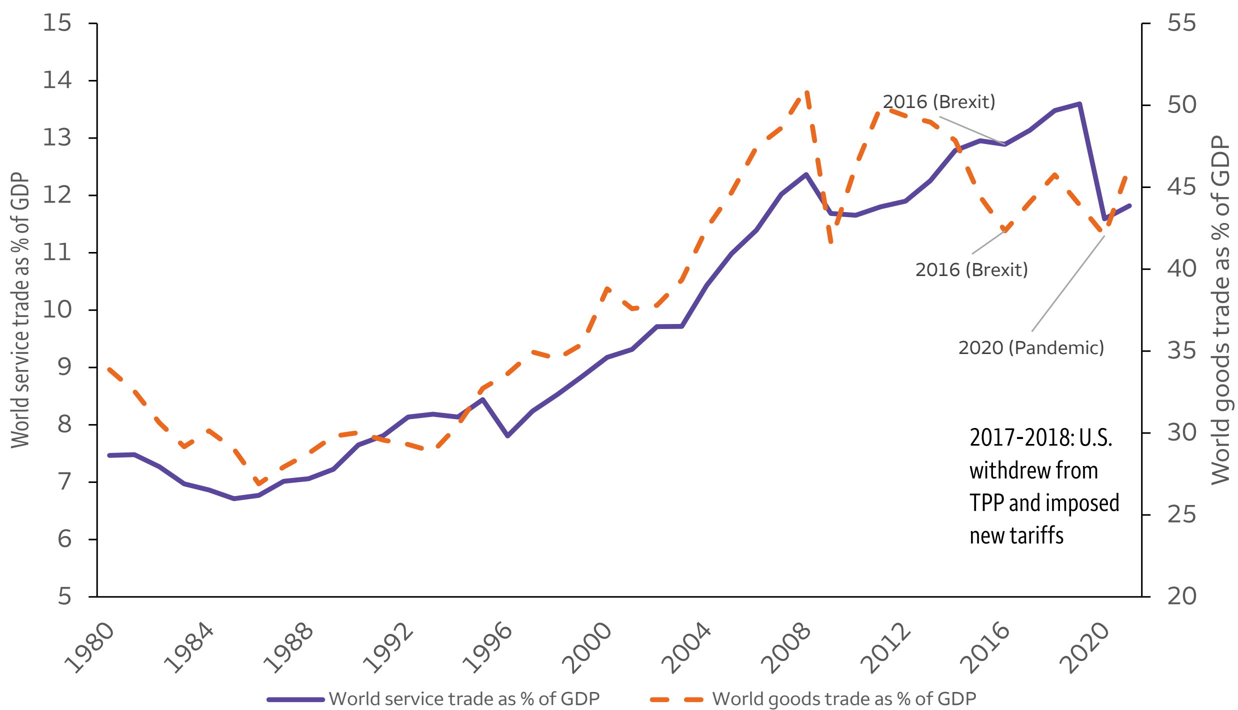
A new trend of globalization emerging in services

As world income grows, the share of household budgets spent on food and manufactured goods should fall, while the share spent on services rises. The growth of global digitalization and the ability to differentiate products through intangibles (e.g., design, marketing, branding) also drives worldwide spending on services.

Chart 1 shows a steady growth of services trade in global gross domestic product in the past decade. Neither Brexit nor U.S. tariffs on goods dented the growth in services trade. The pandemic did weigh on all trade, and the lockdowns and social restrictions hit services trade hardest. However, the eventual end of lockdowns around the world should have the same effect as in the U.S. — that is, stimulate catch-up spending for travel, entertainment, and other services. We expect the trends toward a greater share of trade in services to resume taking share away from goods trade.

Chart 1. Goods and services trade as shares of world economic output



Sources: World Bank and Wells Fargo Investment Institute. Annual data, 1974 – 2020. GDP = gross domestic product. TPP = Trans-Pacific Partnership.

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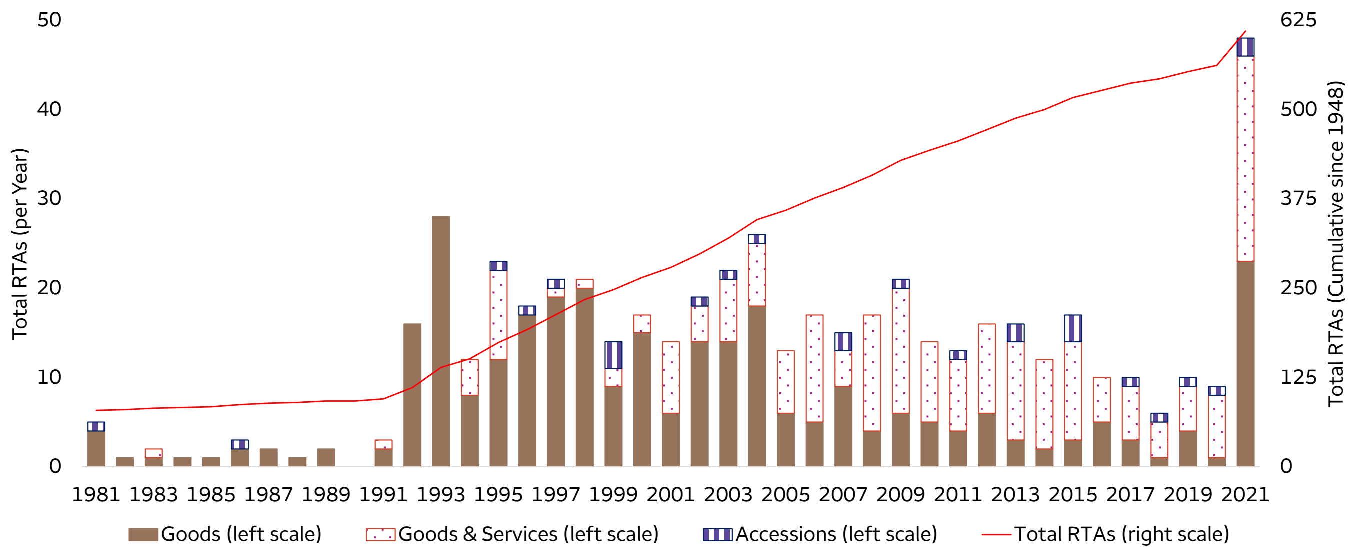
How do we expect globalization to evolve over the coming decade, especially with respect to supply chains?

Regional trade agreements (RTAs) are one adjustment

Chart 2 illustrates that RTAs have been a popular choice for countries throughout globalization's 30-year surge. The growth in RTAs predates China's ascension to the World Trade Organization by a decade and the breakdown of the Doha multilateral trade talks by a decade or more. (The decline in RTAs from 2017 – 2020 could have been due to the increase in U.S. tariffs, but the RTA surge in 2021 suggests that RTAs are returning as tariff threats recede.)

The chart also shows that the majority of RTAs since 2005 are for services trade, underscoring that total global trade is not declining as much as it is shifting from goods to services (as seen in Chart 1), and Chart 2 shows that 2021 is the most prominent example of that shift so far. Additionally, the growing number of services RTAs is attracting new accessions. From 2005 – 2021, the number of new countries joining existing RTAs via accessions exceeds the cumulative RTA accessions from 1949 – 2004. Looking ahead, we expect RTAs to facilitate growing services trade and to create investment opportunities.

Chart 2. RTAs show how globalization is changing, not dying



Sources: World Trade Organization secretariat and Wells Fargo Investment Institute. Data as of March 5, 2022. RTA = Regional Trade Agreement.

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Globalization and the new vulnerabilities of supply chains

Changes to global supply chains are another way that globalization is adjusting. The COVID-19 pandemic disrupted global supply chains almost immediately, and calls to reshore critical supply chains have become common. Changes to the traditional model of highly efficient, but globally fragmented and inflexible supply chains can take several forms, as summarized in Table 1.

Table 1. Regional trade agreements made or joined from 2005 – 2021 by countries within and across two groupings

Strategy	Strategy description	Factors limiting usefulness or availability for quick implementation
"Just-in-case" inventory management	Retain international supply chains, but create additional, redundant supply chains.	Redundancy adds to costs.
Reshoring (onshoring or bringing production home)	Relocate production to home-country market.[8]	Limited material and labor availability; costs to establish a home-country supply chain.
Friendshoring	Develop deeper supply chains with allies.[9]	"Friend" country may have many of the same material and labor limitations; still need to set a home- or friendly-country supply chain.
Nearshoring	Move production to a country closer to the home consumer market, one that has cost advantages and available labor or materials.	It may take years to replicate the supply chains from China and Southeast Asian economies — especially to reconstruct their inputs, quality control, and transportation networks.

Sources: World Trade Organization and Wells Fargo Investment Institute, August 15, 2022.

8. A recent survey showed two-thirds of the 125 U.S. and European firms surveyed are willing to bring some of their Asian production home by 2025, including 20% of respondents who intend to relocate entirely to their home market. See BCI Global, February 17, 2022.
9. This proposal was a highlight in an April 2022 speech by Treasury Secretary Janet Yellen, outlining a new economic order in an increasingly polarized world. Remarks by Secretary of the Treasury on the way forward for the global economy, U.S. Treasury Department. April 13, 2022.

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Complete reshoring is not practical near-term

Reshoring is a popular idea, but shifting supply chains built up over many years is complex and unlikely to develop quickly. Limitations include:

- Resources – Some supply chains simply cannot reshore due to a lack of critical raw materials.
- Labor – The U.S. may not have enough workers to reshore production. New research from Deloitte and The Manufacturing Institute project that between 2020 and 2030, 2.1 million manufacturing jobs will be unfilled in the U.S.
- Manufacturing hubs – China and Southeast Asia have established manufacturing networks that will be difficult to recreate. In addition, China's factories increasingly feature automation and benefit from a well-developed port and rail network.

Nearshoring seems more likely

The pandemic and the war in Ukraine have given nearshoring greater visibility as a means of minimizing transportation disruptions and restraining soaring freight and fuel costs. The strategy can involve supplier buyouts or bringing contract work in-house. Shorter, more reliable supply chains can be a cost-effective alternative to the redundancies built into far-flung networks. Nearshoring also allows firms to respond quickly to shifts in consumer preferences. Dollar strength has added to nearshoring's cost advantage compared to reshoring by U.S. firms.

Sustained nearshoring may have several potential implications for investors:

- Our September 2021 report on globalization highlighted a likely shift to state-of-the-art production centers with higher labor costs, implying greater investment in automation and other labor-saving equipment. This development favors the U.S. and industries that emphasize robotics, artificial intelligence, and machine learning.
- The report also noted that nearshoring promotes regional opportunities and, thereby, a more selective geographic focus on areas tied more closely to major economic centers in the U.S., China, India, and, to some extent, Europe.
- If China's economic growth lags the U.S. pace in the coming years, investors may want to favor economies in the Western Hemisphere, as U.S. firms rotate production away from Asia.
- For the U.S., infrastructure and other investments in new production facilities also imply new opportunities for services exports in data connectivity, software, and other intellectual property, financial, and other business services, where the U.S. historically has held a global advantage.

For perspective, nearshoring could take years to replace supply chains in China and Southeast Asia with sufficient capacity from suppliers and the right raw materials, quality control, and upstream networks. Other issues can extend the gestation period even further. For example, Mexico seems an attractive nearshoring target, considering its proximity to the U.S., its regional free trade agreement with Canada and the U.S., and existing manufacturing and transportation networks. However, capacity in Mexico is tight or nonexistent for certain pieces of equipment and other, more sophisticated components.

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What evolving globalization means for investors

One hundred years ago, a world war short-circuited developing globalization. Short of another world war, we see the events of the past several years as disturbances that incentivize consumers, firms, and governments to adjust globalization, not end it.

We expect globalization to continue its transition away from goods, toward a model that places a greater emphasis on services. Our work also suggests that corporations worldwide will look to diversify their global supply chains to include reshoring and nearshoring, even as some U.S. multinationals continue to compete effectively in China or to source goods from China, India, and Southeast Asia.

In this environment, we see five particular global investment trends that should drive capital flows over the next decade:

1. Geographically, we favor U.S. large- and mid-cap equities first, then equities in parts of emerging Asia (especially China and India).

   We view the U.S. as having overwhelming advantages in services and technology, and in highly adaptable multinational companies. We favor parts of emerging Asia over Europe and Japan because of the competitive advantage in technology and production capabilities, especially in manufacturing (China) and services (India), and in the Southeast Asian economies that form part of China's industrial structure. Their growing middle-class consumer bases and spending trends reinforce our outlook for increased domestic production.

2. Our expectations for increased trade in services should benefit the U.S. Information Technology, Consumer Discretionary, and Health Care sectors, especially among the multinationals that compete against local firms in international consumer markets.

3. U.S. firms increasingly could use advanced technologies to offset the disadvantages of fewer workers and higher wages, compared to other countries.

   Our report "Transformative Technologies: Investment Opportunities in Artificial Intelligence and Genomics", April 2022, outlines trends in artificial intelligence and machine learning that have potentially disruptive effects on industries from transportation, to supply-chain management, to autonomous driving. The report also lists opportunities for qualified investors, who may be looking for longer-term investments that may offer illiquidity premiums.

4. Increasing U.S.-China political tensions should also favor U.S. multinationals that can compete across both countries.

   We expect that U.S. multinationals in the health care, financial services, pollution control, and agriculture industries can compete effectively in China, because these local industries are underdeveloped. Those investors with lower risk tolerance may find such opportunities attractive ways to take international exposure and let the U.S. multinationals manage the risks involved with local government regulations, taxes, and exchange rates.

5. The growing attraction of nearshoring should promote more selectivity in regional opportunities, even if China's economic growth lags.

   We are looking first for international opportunities around Asia, but also potentially in Latin America if China's growth lags and if U.S. firms are able to make greater use of the labor and natural resources there.

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